Office of Chief Counsel
Internal Revenue Service

memorandum

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date: September 22, 2000

to: Chief, Appeals Division, Midwest District
Attn: Steve Onken

from: District Counsel, North Central District, St. Paul

ubject: **Deduction of Minnesota Real Estate Taxes**

Issue

What are the federal income tax ramifications of Minn. Stat. § 275.28, subd. 3 and related sections on real estate taxes for cash and accrual basis taxpayers.

Facts:

A cash-basis taxpayer purchases property in Minnesota on December 2, 1996 and pays property taxes at the time of purchase. 1996 Minnesota property taxes are payable in two equal installments on May 15 and October 15, 1996.

Analysis

Cash basis taxpayers:

I.R.C. § 164(d) provides for allocation of taxes between seller and purchaser for any real property tax year in which property is sold. For cash basis taxpayers, Treasury Regulation 1.164-6(d) governs both deductibility and apportionment of real estate taxes. Treas. Reg. § 1.164-6(d)(3) provides that where the tax is not a liability of any person, the person who holds the property at the time the tax becomes a lien on the property shall be considered liable for the tax. In Minnesota, real estate taxes operate exclusively in rem, and the statutes impose no personal obligation upon anyone to pay them. U.S. v. Consolidated Elevator Co., 141 F.2d 791 (1944).

Taxes become a lien on the property on the day that they are assessed. Minn. Stat. § 272.31. Pursuant to Minn. Stat. § 273.01, the county assessor "assesses" the property, i.e. determines the value of each parcel of property, subject to the tax as of January 2 of the tax year, which is the "calendar" year. Carpenter Foundation v. Washington County, 365 N.W.2d 772 (Minn. 1985); Merle-Smith v.

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Minnesota Iron Co., 262 N.W. 865 (Minn. 1935); In Re Calhoun Beach Holding Co., 287 N.W. 317 (Minn. 1939).

Under prior Minnesota statutes, the assessment date was May 1. Revenue Ruling 71-74, 1971-1 C.B. 64, held that the change in assessment dates from May 1 to the preceding January 2 violated § 461(d)(1) and, accordingly, that the lien (assessment) date in Minnesota remained, and continues to be, May 1.

Section 461(d) provides that in the case of an accrual basis taxpayer, to the extent that the time for accruing taxes is earlier than it would be but for any action of any taxing jurisdiction taken after December 31, 1960, such taxes shall be treated as accruing at the time they would have accrued but for such action by the taxing jurisdiction. The accrual date for real property taxes is the lien date. Treas. Reg. § 1.461-1(a)(2). By accelerating the lien date, the accrual date for real property taxes was accelerated from May 1 to January 1. Rev. Rul 71-74, 1971-1 C.B. 64.

Although the relevant Minnesota statutes have been amended since the 1971 revenue ruling, the effective lien date for Minnesota real property taxes under Minnesota statutes remains January 2. Consequently, we believe that Revenue Ruling 71-74, 1971-1 C.B. 64, remains authoritative for the determination of the deductibility of real property taxes. Therefore, because the seller owned the property on May 1, when the tax became a lien on the property for federal income tax purposes, the seller is liable for the real property tax for 1996.

Where a cash basis taxpayer buys real property from a seller who is liable for the real property tax for the real property tax year, Treas. Reg. § 1-164-6(d)(2) applies. Treasury Regulation 1-164(d)(2) provides that if real property is sold during any real property tax year, the portion of the real property tax allocable to that part of the real property tax year which ends on the day before the date of the sale shall be treated as a tax imposed on the seller, the remainder is treated as imposed upon the purchaser. This rule applies whether or not the seller and the purchaser apportion such tax. Treas. Reg. § 1.164-6.

The "real property tax year" for purposes of I.R.C. § 164(d), refers to the period to which the tax relates. Treas. Reg. § 1.164-6. Minnesota Statute § 275.28, subd. 3 defines the "real property tax year" in the state of Minnesota, as that term is construed under I.R.C. § 164(d) and Treasury Regulation § 1.164-6. Minnesota Statute § 275.28, subd. 3 states:

> "Taxes on real and personal property shall be related to and designated on the property tax statement by the year in which they become payable but the liens shall relate back to the assessment date preceding except as otherwise provided. For cash basis taxpayers, taxes on real and personal property shall relate to the year in which they become payable. For accrual basis taxpayers, taxes on real and personal property shall relate to the year in which the lien

arose."

Consequently, for cash basis taxpayers, the year in which the real property taxes become payable coincides with the year to which such taxes relate (i.e. the real property tax year). This permits the buyer of real property in Minnesota to deduct in the year of sale, that portion of the real property taxes allocated to him under section 164(d).

Therefore, if a cash basis purchaser buys real estate on December 2, 1996, the portion of the real property tax allocated to December 2, 1996 through December 31, 1996 is treated as imposed upon the purchaser. The portion of the property tax allocable to January 1, 1996 through December 1, 1996 is treated as imposed upon the seller. The purchaser paid 1996 taxes when he purchased the house and can deduct his portion in 1996; the seller can deduct the remainder.

The seller should have already paid all of the 1996 taxes, because they were due on May 15 and October 15, 1996. In this case, one would presume that the buyer would have paid only 1/12 of the 1996 taxes when he purchased the home in December 1996. This would essentially reimburse the seller for the taxes that he has already paid for December.

If, however, the seller has not paid the 1996 taxes and they are delinquent, then perhaps the buyer is paying all of the 1996 taxes in December. In this case, the buyer can still only deduct his portion of the 1996 taxes and the seller can deduct his portion, as determined by section 164(d).

Accrual basis taxpayers:

The definition of "real property tax year" in Minnesota Statute § 275.28, subd.3, does not affect the deductibility of real property taxes by an accrual basis taxpayer. The determinative factor in ascertaining the deductibility of real property taxes by an accrual basis taxpayer is the lien date. Treas. Reg. § 1.461-1(a)(2); Rev. Rul. 71-74, 1971-1 C.B. 64. The lien date, as discussed above, is May 1 and has not been changed by the definition of "real property tax year" in Minnesota Statute § 275.28, subd. 3.

Under federal law, an accrual method taxpayer generally incurs a liability in the taxable year that all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. See Treas. Reg. § 1.446-1(c)(1)(ii). Economic performance occurs as the tax is paid to the government authority that imposed the tax (payment rule).[1] § 1.461-4(g)(6). Therefore, although the amount of property tax liability can be determined with reasonable accuracy on May 1, the lien date, an accrual basis taxpayer cannot deduct property taxes until they are paid. § 1.446-1(c)(1)(ii).

In our case, if the cash basis purchaser purchases Minnesota property on December 2, 1996 from an accrual basis seller, the lien attached on May 1, 1996. By the time the sale takes place, the taxes should have been paid in full and the seller would have incurred liability for the tax. However, the seller may not deduct all of the 1996 taxes.

I.R.C. § 164 (c) denies a taxpayer a deduction for taxes that are treated as imposed on another taxpayer under I.R.C. § 164(d). Section 164(d) apportions the tax between the purchaser and the seller. Therefore, the accrual basis seller can deduct his 1996 portion, in 1996 and the cash basis buyer can deduct his portion in 1996, as determined by section 164(d).

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[1]There are two exceptions to the economic performance rule: (1) an accrual basis taxpayer may elect to accrue taxes ratably under 461(c), or (2) an accrual basis taxpayer may qualify for the recurring item exception under 461(h)(3).